

COMMERCIAL REAL ESTATE LENDERS

REAL ESTATE
EXECUTIVES

Special Report on Commercial Lending

Paul Braun
Managing Director

REAL ESTATE VALUES IN THE CURRENT LENDING ENVIRONMENT

What has been the impact in Canada on real estate values as a result of the restrictive and difficult lending environment? 2009 has proven to be a very confusing and perplexing year for real estate investors and owners. We began the year with the knowledge the economy was in a state of flux, the financial system was in ruins and that credit was difficult, if not impossible, to obtain. The obvious conclusion, real estate was going to be significantly re-priced. The common thinking expressed the logic that owners of real estate would be forced to sell because of the lack of the availability of debt and this combined with declining real estate fundamentals would create "bargains" for those purchasers with real equity. While in the U.S. this turned out to be true, in Canada the story has been a little different.

It is true that just as in the U.S., both the Canadian economy and its financial system has sustained some setbacks. In Canada these setbacks have been far less severe. Our economy has proven to be more resilient and thanks to stricter regulations our banking system has proven to be far more stable. However, our financial institutions have not made it easy to borrow mortgage debt both by restricting the availability of funds and toughening the underwriting criteria. Logic would suggest that 2009 would have been the perfect environment for real estate "bargain" hunting, but "bargain-basement" pricing never materialized. There was no "meeting of the minds" between vendors and purchasers as far as real estate pricing is concerned and the volume of real estate transactions is down dramatically in 2009.

There are several possible reasons for this. While the spread over Government of Canada Bonds for mortgage debt increased, Bank of Canada policy has kept interest rates at low levels and the absolute cost of borrowing has not increased significantly. In addition, spreads that were earlier in the year between 350 to 400 basis points over Government of Canada bonds have been reduced to a level of 275 to 300 basis points making refinancing by property owners with maturing mortgages more affordable.

Compared to the U.S. debt is less of a factor in driving Canadian real estate values. U.S. real estate capital totals approximately 4 trillion dollars. An amount that is over 21 times Canadian real estate capital of approximately 190 billion dollars. This is only part of the story. In the U.S. public and private debt represents 83% of real estate capital while in Canada it represents only 40%. Accordingly, U.S. equity of 681 billion dollars when compared to Canadian equity of approximately 113 billion dollars is only 6 times the amount of equity invested by Canadian public and private entities. This results in real estate leverage being less impactful on the volatility of real estate values.

Cap rates to a large extent have been determined by the spread required by institutional investors over 10-year Government of Canada Bonds to compensate for the perceived risk in owning real estate. Historically this spread has been approximately 300 basis points. In other words, if GOC bonds are trading at 6%, institutional grade real estate should trade at 9%. During the first 7 years of this decade this spread was squeezed to as low as 160 basis points, resulting in cap rates in the 6% range for institutional grade property. With changing economic times and the reduced availability of debt, in Canada the spread has increased to the historical level of 300 basis points, but with 10-year GOC bonds at 3.5% the resultant increase in cap rates has not been as dramatic as one would have originally thought, especially since many financial institutions acquire real estate on an all cash basis. The more "dramatic" rise in cap rates has been in real estate that is not considered "A" class, primarily because most non-institutional buyers require debt. Ultimately, real estate values will stabilize when the "risk" is priced into the prevailing cap rates. The debt market is telling us, at least in Canada, that to a large extent cap rates are returning to historical levels, that is approximately 300 basis points over 10-year GOC bonds for institutional grade properties.

What does this mean if you are a property owner and need to refinance maturing debt? Ultimately the amount of a loan will be determined by the value of the property. It appears that real estate values have not decreased to the extent that was anticipated at the beginning of 2009. A lender's underwriting criteria might have become more rigorous to the extent that debt service coverage ratios have increased and loan to value ratios have decreased but the value base on which the loan will be determined will be higher than might have been anticipated earlier in the year. Since lenders' spreads are decreasing and GOC bond rates are very low, loan amounts should be relatively attractive and not put a property owner in the position of having to sell or inject large amounts of equity. There is some more positive news for borrowers. The amount of mortgage funds available has been increasing encouraged by a perceived "bottoming out" of this down cycle and increased liquidity in the financial system.

In summary, the Canadian financial system did not suffer the same shocks as occurred in the U.S. nor did the economy experience as deep a decline. Owners of commercial real estate are experiencing a more difficult borrowing environment but this has not reflected significantly in the valuation of real estate. The Canadian real estate market does not rely on debt to the extent that it does in the U.S. and as a result the increase in Canadian cap rates has been far more modest than in the U.S. In fact, it seems that the main determining factor for the increase in cap rates is more closely related to the historical relationship between a purchaser's risk adjusted cap rate requirements and the spread over GOC 10-year bonds. In conclusion, it does not mean that it will be easier to obtain debt. Stiffer underwriting criteria is still being applied by lenders but the reduction in real estate values will not be as onerous as first thought at the beginning of 2009.